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UNITED STATES SEED ACT

ASSISTANCE STRATEGY

FOR

ESTONIA



1993-1995

**Submitted by American Embassy Tallinn
Approved, July 22, 1993**

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UNITED STATES ASSISTANCE STRATEGY FOR ESTONIA 1993-1995

OVERVIEW

Since regaining independence in August 1991, Estonia has been immersed in enormous and complex transitions - from a centrist Soviet government to a decentralized pluralistic democracy; from a state controlled economy to an open market system; and, from a vassal republic to a free independent country. By any measure, Estonia has made remarkable progress and it remains committed to completing these transitions as rapidly as possible. Nevertheless, the process is a formidable undertaking. It involves nothing less than reforming every sector in the country, reeducating the people, and restructuring the legal and social systems which were imposed on the country over the last fifty years. All these reforms are being undertaken simultaneously with few resources and even less experience.

While Estonia's reform process is moving briskly, the reforms are not complete and few of the foundations of Western society created during Estonia's brief 22 year independence from 1918-1940 survived Soviet annexation. Estonia also remains vulnerable to events beyond its control -- particularly those in Russia and the remainder of the former Soviet republics. The donor community is collaboratively supporting Estonia's reform efforts with modest assistance programs responding to targets of opportunity rather than any fixed development strategy. Government is not yet capable of leading this process but is maturing.

With increased donor assistance from the region, Estonia's own momentum of success and its natural affinity to integrate with Scandinavia and Europe; U.S. Government (USG) assistance has a limited role. Having help catalyze major Estonian reforms, U.S. assistance will focus in three areas - 1) strengthening pluralistic democracy and key institutions that manage or support private sector development; 2) creating an open market economy and ensuring that those reforms are sustainable; and 3) supporting environmental protection. The U.S. will also provide regional assistance in those areas which are of common interest to all three Baltic countries.

The U.S. program will: assist local election processes, promote governmental reform (principally streamlining and decentralization); support privatization transactions,

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the growth of small and medium business, and trade and investment; coordinate regional energy policies and investments; and, promote clean-up and/or prevention of industrially-caused pollution in selected geographical and/or sectoral target areas and strengthen environmental agencies and policies. The assignment and costing of environmental liabilities and the capitalization of pension funds will also be addressed in the context of support to privatization transactions. Estonia's progress in institutionalizing these reforms should be reviewed in 1995 to reassess future directions for U.S. assistance.

THE CURRENT SITUATION

Estonia has made great progress in establishing a vibrant, open democracy and has completed most of its government reforms at the national level. Since June 1992, Estonia has approved a national constitution, elected a national parliament, established diplomatic relations and membership in the international community (including the United Nations, World Bank and Council of Europe) and created a small defense force. Political parties are active and very vocal. State-owned television, radio, press and other media are gradually being privatized. While Estonia's citizenship law is among the most liberal in Europe, Russian-speaking minorities continue to object to the citizenship requirements and their diminished role in national political life although they participate in local government and the economy.

Despite this progress, some problems still remain. Simultaneous reform in all sectors and all ministries has defused government efforts and sapped its energies. Government suffers from shortages of experienced staff and the policy framework for further reform is not yet complete. The lack of modern office equipment impedes basic operations and government's ability to keep pace with increased workloads. Outside support is needed to continue the reform program in the national ministries, to increase the administrative capacity in national and local government institutions, and to lay the political and administrative structures for local elections in the fall, 1993.

In the economic sphere, Estonia is making significant strides in reestablishing an open market system, but the economy still faces many obstacles. Estonia successfully introduced a convertible currency in June 1992 that has remained remarkably stable for the last year. Its success has increased public and business confidence in Government and has made its economic reforms more acceptable. Nevertheless, economic restructuring remains slow because Estonia has limited natural resources, capital, and trained human resources, at a time when government is undertaking major reforms in all sectors simultaneously. With only 1.6 million people Estonia is not so attractive to investors as a market, but its highly trained work-force, excellent infrastructure and

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geographic location make it ideal as a production platform for value-added product assembly for resale to Scandinavian and the former Soviet republic markets.

Not surprisingly, Estonia's commercial future is becoming increasingly more closely aligned to Europe and Scandinavia and their commercial and civil law traditions. Consequently, it is the European interests that are currently driving the development processes in the Estonian commercial sector. Although U.S. investment and trade links with Estonia are growing in selected areas, they are likely to remain relatively minor by comparison for some time. The legal framework for commercial operations also remains too murky for large investors - no laws for land ownership and collateral, unresolved restitution claims and unresolved debt and environmental liability of state owned firms being sold and privatized.

Estonian Government priorities are to: promote the rapid privatization of state-owned enterprise, settle land claims to promote the growth of business and private agriculture, encourage foreign investment through reform of industry and commerce, place local and foreign investment on an equal footing through adoption of appropriate commercial laws, promote local government reform, adopt new tax systems, strengthen defense forces, clean the environment, and establish closer ties with the international community.

U.S. INTERESTS

U.S. interests in Estonia are to promote the country's independence and sovereignty in accordance with principles of international law. U.S. strategic interests in Estonia are limited. We want to encourage regional stability. A peaceful transition by all States in the region to pluralistic democracies with open market economic systems helps ensure that this goal is attained. To that end, the U.S. has supported Government's request for the removal of Russian troops from Estonia at the earliest possible time.

U.S. commercial interests lay in encouraging U.S. trade and investment. At present, there are small, but growing U.S. investment and trade arrangements - primarily in bottling, potato and starch production, alcohol spirits, wood products, auto sales, construction, textiles, high technology fabrication and assembly, and commercial building investments. With economic and political stability and a solid industrial base with good infrastructure and transportation links to the region, Estonia serves as an excellent potential staging area for industrial fabrication and assembly for export sales to Russia and the Scandinavian region. For this reason, the U.S. ranked fifth in volume of bids

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submitted during the first tender on large enterprise privatization in fall 1992, behind the Nordic countries, but above Germany, Russia, and Poland. Its small population does not make it a large potential market for U.S. products other than for value-added assembly and re-export to the region.

Successful development investments in Estonia have significant impacts throughout the region because as a former Soviet Republic with a history of Soviet-style systems, Estonia serves as a model for the economic reform processes now underway in Russia and the Newly Independent States (N.I.S.). Success here also stimulates the economies of its Nordic neighbors and promotes regional trade.

U.S. ASSISTANCE IN PERSPECTIVE

U.S. assistance is characterized by practical, highly focused programs of support. The program currently provides long- and short-term U.S. technical advisors, limited commodities, special studies, training, and emergency food and medical assistance to Estonia. Last year, official U.S. bilateral assistance totalled \$7.8 million in four priority areas - democratization, privatization and private enterprise (including agriculture), emergency energy, and humanitarian assistance programs (including environment). Most of this assistance was under U.S. grants and contracts but a large part was also channeled from A.I.D. through other U.S. Government agencies - Treasury, Commerce, U.S. Information Agency, Trade and Development Agency, and the Environmental Protection Agency.

An additional \$21.3 million in Public Law (P.L. 480) food assistance from the Department of Agriculture was provided in response to a severe drought which reduced local agricultural production by over one-third. The Estonians recently declined further P.L. 480 feed grain assistance for fear it would disrupt and prolong the painful agricultural transition. Some two million dollars in emergency medical assistance was also provided through private U.S. voluntary organizations such as Project Hope.

ROLE OF OTHER DONORS AND LENDERS

The international donor community has responded quickly to help Estonian reform efforts and, as expected, most assistance comes from Estonia's Nordic neighbors. Prime Minister Vähi in February 1992 praised the U.S. for providing more up-front aid than any other donor. The U.S. is now the fourth ranked donor. In rank order, Estonia's largest donors are the European Community (EC), Sweden, Finland, USA, International Monetary Fund (IMF), World Bank, Japan, European Bank for

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Reconstruction and Development (EBRD), the United Kingdom, Denmark and Germany. As of May 1993, cumulative commitments of technical assistance to Estonia from other donors in sectors of interest to the U.S. total at least \$27 million.

The U.S. established the informal donor coordinating mechanism in 1992 under which donors actively collaborate on country programs. The process is minimized, however, because most programs are designed and initiated by home ministries with little involvement by the donor's local embassy in line with the general operating agreement of the G-7 in 1991 for donor assistance. At the other extreme, while Government has developed a set of development priorities, it is not adequately staffed to take a lead role to actively coordinate assistance programs or establish a comprehensive development strategy. The result is that donors respond to targets of opportunity - a "demand driven" development program that has been viewed, and criticized, by some Ministries as "donor" driven. Nevertheless, the general consensus among the donor community on Estonia's major development priorities is: reestablish Estonian sovereignty; promote democratization; create an open market economy; and, support social/environmental programs.

U.S. ASSISTANCE STRATEGY

Much remains to be done to institute a sustainable development process in Estonia. It has limited manpower, few natural resources, and little capital to invest in solutions. The U.S. development program can assist Estonia in meeting its priorities, particularly in completing its open market economic reforms, and assisting selectively in democratic reforms. Our assistance will ensure that U.S. business has an equal opportunity to participate in local and regional markets, and can stimulate U.S. private investment in the region by linking U.S. firms with Estonian development opportunities. Program success here can have positive impact in the region - since Estonia was once considered a Soviet Republic, lessons learned from reform efforts here can help guide reforms in the N.I.S.

With limited Support for Eastern European Democracy (SEED) Act funding expected at the six million dollar/year level over the 1993-1995 planning period, U.S. assistance should focus only on those program areas which will: have the greatest impact, provide long term solutions, strengthen government institutions and local systems, and promote the self-sustaining development process. The programs need to complement other U.S. and other donor programs and, as much as possible, be synergistically coordinated to create a critical mass of expertise to resolve targeted Estonian

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development problems. U.S. assistance needs to provide straightforward, practical solutions that minimize management and cost burdens to government.

PROPOSED CHANGES IN ASSISTANCE METHODS

Consistency, momentum and accountability in the program also need to be reinforced. Implementation of the program should consequently shift to: (1) reduce the number of grant and contract programs from the 43 activities into more effective delivery vehicles; (2) consolidate the program sub-sectors and target specific geographic areas, e.g., promote agribusiness development and environmental programs in selected areas rather than country-wide to better focus program delivery and improve program impact; (3) favor longer-term U.S. advisor teams over short-term individual advisors, so as to address multiple targets simultaneously in a synergistic way; (4) incorporate follow-on visits by the same advisors to review progress, instill accountability in both host country counterparts and advisors, assess lessons learned, and revise assistance incrementally in line with this learning; (5) promote permanent linkages between the U.S. institutions providing the support and local recipients to reinforce consistency in approach, reliability and accountability; and, (6) broaden the base of participant trainees - in concert with institutional strengthening programs in conjunction with the existing U.S. defense funded language center at the Estonian Academy of Public Safety in Tallinn to broaden the base of Estonian officials for U.S. sponsored training.

PROGRAM GOALS AND TARGETS

This strategy assigns priority to three major program goals: strengthen pluralistic democracy; support economic reforms and growth; and support environmental protection.

PROGRAM GOAL #1: STRENGTHEN PLURALISTIC DEMOCRACY

With the adoption of its Constitution and the election of its national leaders and parliament, Estonia has taken major steps in creating a pluralistic democratic society. Media privatization is proceeding well and Estonia's liberal policies on citizenship and minority rights are well established. U.S. assistance is needed only in support of specific aspects of government reform and limited support for local elections in the fall 1993. Special care will be taken to insure the inclusion of all political parties as well as the Russian minority in technical assistance activities in this area.

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Program Objective #1: Support Government Reform

Government is nearing completion of its program to consolidate and streamline its ministries and agencies. Serious staff and equipment shortages impede further reform progress. By contrast, local government reform is only now beginning, with elections scheduled for October 1993. Future assistance in this area should focus on strengthening national and local institutions to assume the duties of decentralization and support local government elections with assurances that any materials and training provided be available in Russian and that Russian participants be invited.

Target #1: Support Streamlining of Ministries at National Level

Government's reorganization of national and local institutions will provide more efficient operational structures. Parliament is also in the midst of reforming local government to vest more authority at the local level to ensure that decisions are made at the lowest possible political level. Prerequisite action for the fall elections of local offices will be completion of ministerial consolidation at the national level. The creation of political parties occurred in spring 1992, and the first nationally elected government took office only in October 1992. The new government retains only a slight majority in the parliament but its coalition remains stable while opposing groups are now fragmenting. Consequently, structural reform now underway is likely to remain in place for the foreseeable future. Long term U.S. advisors now in place at the Ministry of Finance and Central Bank coupled with short/medium term U.S. advisor teams in other areas, will support completion of national ministerial consolidation and assist in establishing operational and policy requirements needed to implement decentralization and government reforms.

Target #2: Develop Local Government Management Training Programs

The current structure of local government in Estonia includes 249 municipalities, 15 districts, and six republican cities which function as districts. The most recent law related to local government was passed in 1989, during the Soviet era, and it only sets out basic concepts and structures, with little guidance on specific responsibilities. Faced with the limitations of that law, municipalities and districts have been left on their own to work out local relationships and responsibilities. Through the State Secretary, the Government of Estonia is currently drafting new legislation to restructure local government, and is considering a proposal to make the district level into an arm of the central government.

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Under this target, the USG will focus the technical assistance of existing programs to provide support to the emerging school of social science at Tartu University to aid in curriculum development, faculty training, and pilot training efforts.

Target #3: Strengthening Governmental Institutions

Despite consolidation and reform, national and local institutions will continue to reflect operational weaknesses because most public officials have limited experience in management and public administration. The majority of ministerial appointees are new to Government and most new mid-level administrators are under thirty-five years of age. Few have traveled outside Estonia - most travel has been to the USSR. None of the new managers have extended exposure to Western concepts of government or private sector operations although many are quite good in their technical areas. The reform processes throughout the economy will be facilitated and made more sustainable by providing limited training in the U.S. to key officials in ministries with which U.S. program assistance is targeted, including: Finance, Economy, Foreign Affairs, Education, Justice and Environment. The Ministry of Agriculture is not selected because it is receiving adequate institutional support from other donors.

Arrangements are being made to broaden the group of officials permitted to use the U.S. funded International Military Education and Training (IMET) English language facility in the Estonian government. Highly focused one/two week seminars in Estonia would focus on reaching larger ministerial units; materials would be prepared in Estonian, and when appropriate Russian, and preshipped to permit participants greater learning opportunities.

PROGRAM GOAL #2: SUPPORT OPEN MARKET ECONOMIC REFORMS

Estonia has taken bold steps to promote an open market economy. In June 1992, it adopted a convertible currency that is perhaps the single most important factor contributing to economic, political and social stability in Estonia. Government is also a genuinely post Soviet government and fervently believes in free trade and the market economy. It is promoting free trade agreements, completing a basic legal framework to encourage commerce, foreign investment and land ownership, initiating a vigorous privatization program second only to the Czech Republic, shifting sources of raw materials and markets from the N.I.S. to the West, reforming tax and budget systems and maintaining a national budget surplus.

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Estonia only initiated its fundamental reforms less than a year ago, and it still has much to accomplish. Key remaining obstacles to establishment of a dynamic market-oriented economy are: the large number of state-owned industries that are still able to compete unfairly with new businesses, an incomplete statutory and regulatory framework, lack of both venture and working capital, a weak financial and banking sector, a dearth of entrepreneurs trained in Western market systems, a stalled land restitution/land ownership program, incomplete restructuring of the energy and transportation sectors, and government institutional weaknesses that inhibit support for commercial activities.

Program Objective #1: Support Private Sector Development

U.S. resources will be concentrated on targets in support of the private sector side of open market development, specifically selected to address key constraints that inhibit privatization, small and medium enterprise development, and trade and investment. They will also focus on related aspects of energy coordination and environmental clean-up/liability assignment. The five targets for U.S. assistance under this objective are described in the following sections.

Target #1: Support Privatization Transactions

Privatization is the Government of Estonia's highest priority action to create an open private market economy. Estonia hopes to privatize as quickly as the Czech Republic, Hungary and Poland, but has substantially less of the government expertise needed to negotiate and contract deals, hence its dependence on foreign advisors. Thirty-eight of the largest state-owned industries were offered for tender in November-December 1992, 10 contracts were signed by May 10, 1993, and another 18 contracts were signed by the end of July, with several large purchases still under negotiation. It is expected that the privatization effort will be expanded to include over 2,000 state firms. State-owned agricultural assets, forests, transportation, public media, and public housing will be part of the expanded privatization effort.

Long-term U.S. advisors are already in place, providing assistance with the transaction phase of selling state industrial firms. From 1993-1995, this assistance will be continued with emphasis on finalizing the terms of deals with foreign investor interest. Specific U.S. assistance with backward linkages in preparing firms for privatization will also be provided under three specific sub-targets: providing bank training and policy advice in support of privatization, helping the government to cost-out and assign environmental liabilities related to industrial water pollution, and helping to plan on a national scale for the capitalization of pension funds.

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U.S. assistance will not encompass the proposed state holding agency which is likely to be created by the new privatization law, with a mandate to assume authority for restructuring all state-owned enterprises. Other donors will be better placed to handle the potentially large cost of long-term assistance that will be needed by this part of the Estonian Privatization Agency.

With agribusiness and agro-processing comprising fifteen percent (15%) of GNP, and a heavy reliance on domestic production to ensure national food security, privatization efforts throughout all aspects of the agricultural sector are crucial to Estonia's new economic base. Most of the larger state collectives and food processing plants will be privatized as part of the on-going tender process. The remaining collectives/firms need special reform attention. Divestment of Government's monopolistic grain board to private traders and a major adjustment process from excessive quantity to high quality agricultural products responsive to real market demands will be facilitated through U.S. technical assistance and training programs.

Target 1.1: Provide Commercial Bank Training and Policy Advice in Support of Local Participation in Privatization

Half of the bids on the fall 1992 tender of large enterprises were submitted by Estonians, but it has been difficult for them to meet conditions of the tender related to placement of bid bonds, performance bonds, and investment guarantees, since local commercial banks have little experience in commercial transactions that require these types of bank services. General absence of working capital finance in Estonia also cripples local participation in large scale privatization, especially at this stage of land reform, since there is little other collateral that local banks will accept. In-country resident advice to commercial banks will be continued and expanded, as will banker training, under this sub-target, but these activities will be focussed more closely on developing local commercial banks' capacity to provide financing and services in support of privatization and other commercial transactions.

Target 1.2: Support Development of Capacity to Identify and Assign Responsibilities for Environmental Liability

This is an important issue, with long-term fiscal implications, since purchase price, employment, and investment guarantees have been the focus of privatization negotiations to date, with total neglect of environmental liability issues. Environmental liabilities and public health risks could amount to a significant unfunded off-budget government responsibility, dwarfing the present value of sales proceeds, if this issue continues to be

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neglected in deal-making. To the extent possible, efforts would simultaneously create a local capacity to do this work. Environmental liability will be an important topic for the policy and institutional components of the environmental protection program goal (see Program Goal #3 below).

Target 1.3: Help Plan National Capitalization of Pension Funds

At present, large scale privatization attractive to foreign investors are proceeding quickly, with no set-aside of shares to capitalize either restitution or pension voucher funds. Government has intended to use cash from purchase prices to compensate restitution voucher holders. It is unclear whether proceeds will be left for that, after deduction of the government costs of privatization transactions, restructuring and future proposed holding company operations (to manage hard-to-privatize enterprises likely to fall into bankruptcy), and liquidations. Practical policy advice needs to be provided to the Minister of Reform by U.S. advisors, now while there is still time to set aside shares of large scale privatization with foreign investor interest, to capitalize pension voucher funds, and possibly restitution funds, if cash proceeds will not be a feasible source of compensation.

Target 1.4: Help to Promote the Privatization of Health Care

Promote the improved efficiency and effectiveness of health care in Estonian hospitals with the long range objective of preparing the hospitals for privatization. Future health partnerships will establish linkages to administrators in private American hospitals through the Partnerships in Health Care Project with the American International Health Alliance. Partnerships will be selected in Estonia in December 1993 and assistance should be focused on creating linkages to Western expertise that will allow the hospitals to improve the quality of care and business administration to a self-sustaining level.

Target #2: Support Growth of Small and Medium Business

The small group of private traders, service managers and retailers is growing - but few private entrepreneurs are involved in manufacturing. Even fewer in this group have experience in western industrial production or open market economic operations. Overall, this group has basic technical expertise in their particular fields, but they need training in basic accounting, marketing, and business operations, as well as venture capital and credit to start and expand their operations. On-going access to Western business training would ensure they have technical skills as they move beyond

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the start-up phase into operations, and would provide greater assurance of repayment for start-up credit.

Efforts to complete Estonia's legal and regulatory framework are well underway and the need for U.S. assistance in legislative drafting is drawing to a close. The U.S. plans to initiate an assessment of Estonia's current reform legislation status in order to identify areas requiring clarification or additional support. Estonia's preference for its 1939 civil code reflects its recognition that its commercial future is with Europe and its civil law traditions. While this accommodates commercial relations with Europe, legal and government institutions still require strengthening and training in western concepts - particularly in commercial transactions. The present systems are too weak and lend themselves to potential abuse and criminal activity. In order to proceed with large scale privatization through tenders, in the face of weak Estonian legal and judicial systems needed for contract enforcement, clauses in the final deals provide for the designation of external arbitration courts.

This program target will involve a three-pronged approach closely tied to development of key institutions: (1) continued support for local private business organizations and training for small and medium private entrepreneurs through medium term advisors, seminars and innovative public media and television programs; (2) support for training institutions to develop modern marketing, business, and related legal skills; and (3) transitional venture capital and credit for the start-up of new firms from the new Baltic-American Enterprise Fund.

The first element of this strategy component continues support for the strengthening of local private business organizations, especially the Estonia Small Business Association. This may be expanded to provide an institutional base for continuing education for small and medium scale entrepreneurs, and a point of contact for trade and investment linkages. Volunteers from U.S. Private Voluntary Organizations (PVOs) qualified to provide business advice and training to small and medium private businesses will be placed in institutional settings where they can assist a large number of clients to develop business and financial plans, and strengthen particular aspects of their business operations. There are over 9,000 private farms in Estonia today, but agribusiness development needs stimulation. Short term training from both U.S. private sector companies and PVOs can assist new private entrepreneurs to create or expand agribusinesses by providing short-term advice on new technology, potential foreign investors, quality/packaging improvements, and markets. Innovative television program presentations explaining the concepts of a market economy and entrepreneurship to the general public would reach a broader audience than

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conventional projects; the impact could be increased even further by tying the program to more specific follow-on seminars established in conjunction with the Estonian Small Business Association or other donor small business programs.

Second, through support to the development of new curricula, training materials and methods, and faculty skills at Tartu University, U.S. advisors will help train a critical mass of local experts in Western commercial management, marketing, and legal skills needed for new business formation, joint venture investments, mergers and acquisitions, post-bankruptcy liquidations, and international trade practices. The University recognizes that its economic and legal faculties are now irrelevant, and is anxious to work with U.S. advisors to completely revamp and strengthen the business and commercial law aspects of these departments in support of private market development. Given the small size of the faculty in these departments, they will be unable to participate in external long-term training. Assistance will primarily be provided by long-term U.S. advisors resident in country, complemented by some U.S. long-term training for the next generation of teachers.

Third, venture capital to enable the creation of new firms is not available to small and medium sized firms; start-up of the new regional Baltic-American Enterprise Fund will help fill this important financial gap. A minimum target allocation will be established for each of the three Baltic countries, with the remainder of the funds being distributed on a demand driven basis.

Target #3: Provide Trade and Investment Links

Foreign investment is vital to maintain the momentum of private sector creation. It brings a much-needed infusion of capital, technology, product development, quality improvement, and marketing experience, as well as direct access to international markets in some cases. Some foreign investment is occurring spontaneously, and the privatization process also attracts investors. Investors find it difficult, however, to obtain key elements of information on Estonia and its investment opportunities. As yet, there is no local institution capable of serving as a central clearing house for information about the local economy, individual firms, or potential investment opportunities. Similarly, there is no source of information about U.S. opportunities for local entrepreneurs. There is no in-depth international trade experience in any major Government institution; those few who were experienced are now in the private sector. This strategy component will strengthen both government institutions that promote trade and foreign investment, as well as local private organizations that promote business and commerce. As a first step in this information sharing, a regional trade advisor will be put into place to train entrepreneurs

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and officials to create trade linkages to the West. Other surveys and data collection about local business conditions will be initiated through the Estonian Small Business Association which can help U.S. and other foreign investors.

Target #4: Help Coordinate Regional Energy Systems

Estonia's self-sufficiency in electricity and its electricity exports depend on oil-shale deposits which will be depleted within the next fifty years under current rates of usage. In all other energy areas, Estonia must import refined petroleum products and natural gas at world prices. The continued heavy burden on the budget from fuel imports can only be reduced by improving the efficiency of energy use.

Government has initiated reforms in energy use and in electricity production, pricing and distribution. It is undertaking conversion of central heating plants from diesel and natural gas to multiple energy sources (wood chips, oil shale, peat) to improve energy self-sufficiency, though this would involve significant economic costs and efficiency losses. It is also installing metering systems to improve billing and revenue collection and is implementing energy efficiency and weather-stripping programs to conserve energy use.

The regional dispatching center based in Riga is now under the direction of the three Baltic countries, and they are looking for new ways to establish mutually beneficial arrangements among electricity importers and exporters. Regional approaches are also needed to accomplish national energy security objectives, including the possibility of joint ventures. The regional character of the energy systems (electric grid, oil/gas pipelines, regional scale of key facilities like Estonia's oil shale plant) has helped create greater receptivity to regional cooperation in pricing for the use of facilities. There is recognition that unreasonable pricing could lead to a loss of customers (such as Russia, which could pursue other options in the medium term). Although each Baltic country has adopted a goal of national energy self-sufficiency, this is not an achievable or desirable goal in the Baltics' energy sector. The future direction of the energy sector is greater interconnection with the West, which can best be accomplished with Baltic regional cooperation.

The U.S. will support the government's efforts by building the capacity of local private sector firms to produce energy audits and install energy efficiency equipment. The main focus of U.S. assistance will be promotion of regional energy cooperation in economic pricing, operational efficiencies, and least-cost investment decision-making.

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PROGRAM GOAL #3: SUPPORT ENVIRONMENTAL PROTECTION

Environmental pollution in Estonia is a serious public health and economic problem. Pollution through various environmental media and from urban, industrial and agricultural sources affect local regional and transnational populations, leading to the serious degradation and waste of environmental and economic resources. Pollution has been caused by a half century of maldevelopment and neglect and to correct the situation will require economic restructuring and major capital investments and, more immediately, changes in policies and institutions.

Estonia is the recipient of pollution from other nations (mainly air and water pollution from Russia and Latvia, air pollution from Poland and the Ukraine) and contributes to transnational pollution (air and water pollution to Russia and Finland, air pollution to Sweden). Estonia also contributes pollution via air and water to the Baltic Sea.

The principal environmental problems of Estonia are similar to those for the rest of the Baltics and most of Central and Eastern Europe:

- air, water and land pollution from large-scale, heavy industry and mining, using grossly inefficient and obsolescent technology and management systems. The single biggest pollution source is the extraction, refining and disposal of oil shale and its residues.
- air, water and land pollution from large-scale, power generation using oil shale. Electricity exports are one of the few viable sources of foreign exchange earnings for Estonia presently.
- radioactive pollution from uranium processing at Sillamäe and toxic and hazardous wastes from military bases in Tartu, Paldiski and other sites.
- health and ecological threats from water pollution due to inadequate or absent urban wastewater treatment, drinking water supply, agro-processing (large-scale farms, slaughterhouses, tanneries and the like) and forestry industries. These pollution sources affect surface waters (e.g. Lake Peipsi), groundwater and coastal regimes alike.

The most important environmental and health threats come from air pollution, mainly from industrial and power plants using oil shale but also other large and small

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scale fossil fuel users. Water pollution is a close second and solid waste disposal can be a serious local problem. Cumulatively, these problems are beyond the resources of any one donor. The Nordic countries collectively have a wide-ranging aid program which focuses primarily on point source pollution control and technical training. This is also mainly the case for the EC and other European donors. U.S. assistance is currently focussed on environmental economic policy reform, environmental institutional development and pollution prevention related investments.

Program Objective #3: Support a Sustainable Transition to a Market Economy through Environmental Policy, Institutional and Investment Assistance.

The aim of the U.S. environmental protection program is to help Estonia set in place a sustainable economic development path; a prerequisite for successful transition to a market economy as well as minimizing health risks and stopping the waste and degradation of environmental resources. This can best be achieved through an integrated, targeted program of assistance in the environmental policy, institutional and investment spheres.

Target #1: Promote and Support Environmental Economic Policy Reform and Implementation Mechanisms.

The USG will support environmental economic policy reforms and policy implementation mechanisms through short and long term assistance to national Environment, economic and sectoral ministries. This assistance will involve several key ministries, including Environment, Finance, Industry and, possibly, Energy. The assistance will support the development of a sustainable economic development strategy and a case study of policy implementation in northeast Estonia. The policy support will be carried out directly with the government and also through a local environmental policy research institute.

Target #2: Strengthen Government Environmental Institutions at the National and Regional Levels.

The USG will support strengthening of environmental institutions at the national and local/regional levels through technical assistance and "learning by doing" through targeted assistance to the national Ministry of Environment and various government bodies in the case study region of northeast Estonia. The emphasis of the regional activities will lie on environmental monitoring, permitting and management of environmental restoration and protection activities, especially those connected with oil shale extraction, use and waste

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disposal. This activity will also support the environmental monitoring of Lake Peipsi, the productivity of which is being adversely affected by oil shale and other pollution sources.

Target #3: *Promote the Prevention of Industrial Pollution through Demonstration Investments.*

The USG will demonstrate the environmental and economic benefits of pollution prevention through the World Environment Center's waste minimization and environmental assessment program. The main thrust of the demonstrations will be in the oil shale region of northeast Estonia, although other important industries will also be targeted. This program will be further supported by the development of an Estonian "center of excellence" to continue and extend the pollution prevention program.

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POLITICAL ANNEX

Estonia was an independent nation from 1918 to 1940, when it was forcibly incorporated by the Soviets. This illegal incorporation was never recognized by the United States. Estonia emphatically maintains that Russian troop withdrawals remains one of its highest priorities and that the resolution of this issue will exponentially speed economic and political reform. As a result of attrition and unilateral withdrawals, Estonian officials have estimated Russian forces at about 4,000, down from 40,000.

One of the key difficulties in resolving the withdrawal issue is the disposition of the Paldiski submarine naval base, which houses a Russian nuclear reactor used for training submarine crews. On the heels of Yeltsin's October 29 decree suspending troop withdrawals from the Baltics, Russian Deputy Foreign Minister Churkin visited Tallinn on November 3 and stated publicly that the decree was meant for domestic purposes in Russia only and that troop withdrawals would continue. Estonia and Russia have held regular rounds of troop withdrawal talks, and despite the absence of an agreement, withdrawals have continued.

Estonia held its first contested elections for the 105-member Supreme Soviet in March 1990. All residents were eligible to participate in the elections, including the approximately 40,000 Soviet troops stationed there. The Popular Front Coalition, composed of left and centrist parties, gained a parliamentary majority. Estonia reaffirmed its independence in the wake of the unsuccessful August 1991 coup in the Soviet Union. The U.S. formally re-established diplomatic relations with Estonia on September 2, 1991.

During the subsequent cold winter, compounding Estonia's economic restructuring problems, Prime Minister Edgar Savisaar demanded emergency powers to deal with the economic and fuel crises. A no-confidence vote by the Supreme Council caused the Popular Front leader to resign, and a new caretaker government led by former Transportation Minister Tiit Vähi took office.

In February 1992, parliament reinstated Estonia's liberal 1938 citizenship law. Dual citizenship is allowed for those Estonians and their families who fled the Soviet occupation. Accordingly, those who were citizens in 1940 are citizens now. Those who moved in subsequently can become citizens after one year following a two year residence, retroactive to March 30, 1990, and proof of demonstration of a basic knowledge of

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Estonian. Most of the ethnic Slavs (35% of the population) were eligible for naturalization in March 1993. In early 1993, the Estonian Parliament further modified the citizenship law to reduce or waive the language requirement for the elderly and handicapped and waived the language requirement for those who had registered as citizenship applicants with the Estonian Congress in 1989-90. The Government is funding some language training and states that most Russian non-citizens already grasp sufficient Estonian to pass the exam. All registered non-citizens are eligible to vote in municipal elections to be held October 17, 1993.

On June 28, 1992, Estonian voters approved the constitutional assembly's draft constitution and implementation act. The document establishes a parliamentary form of government with a President as head of State and a Prime minister as head of government, based on the German model. Free and fair parliamentary and presidential elections were held on September 20, the first in a free Estonia in over fifty years. Approximately 68% of the country's 637,000 registered voters cast ballots. Ten percent of the Russian population also were eligible to vote. No single party obtained a majority; the top seven parties each received from 7% to 30% of the vote.

The leading Presidential contenders, President Ruutel (43%) and former Foreign Minister Lennart Meri (29%) faced a secret parliamentary run-off to determine the winner. Ruutel's former association with the ruling Communist Party probably helped Meri win on the first ballot. Meri chose 32-year old historian and Christian Democratic Party founder Mart Laar as Prime Minister.

Within ten months after re-declaring its independence, Estonia had obtained international recognition of its status and had drafted and ratified a Constitution. It is now reenacting a series of national laws based on the 1939 civil code. Estonia is now a member of the United Nations, Conference on Security and Cooperation in Europe, North Atlantic Cooperation Council, Council of Europe, and is seeking associate membership in the European Community.

Estonia is firmly committed to creating a pluralistic democratic society. Free speech, unimpeded travel, right of association and to stand for elected political office are all embodied in the new Constitution. Government has also taken steps to extend the protection of basic human rights to all its minorities. In June 1993, it set forth a straightforward citizenship law to permit minorities (Russian citizens) the opportunity to become Estonian citizens. Despite initial tensions with minority groups, it is judged as one of the more liberal in Europe. A host of international organizations have conducted internal investigations and have certified that Estonia is not violating the rights of local

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minority groups. The Helsinki Conference on Security and Cooperation in Europe (CSCE) has set-up permanent offices in Tallinn and Narva to ensure compliance with international accords on the protection of human rights. A CSCE fact-finding mission in November 1992 found no evidence of human rights violations in Estonia.

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ECONOMIC ANNEX

Estonia has made commendable progress in moving to a market economy since the restoration of its independence in August 1991. The successful introduction of its own currency (the Estonian kroon) in June 1992 -- the first attempt by a former Soviet republic to break out of the rouble zone -- has provided the foundation for economic stabilization and restructuring. Hard currency reserves have doubled since the introduction of the kroon and inflation rates have decreased significantly and are now averaging about 2.5% per month.

Most of the legal infrastructure necessary to creating a market economy have been enacted. A few such as land titles, foreign ownership of land, mortgage and collateral law, bankruptcy, commercial law, negotiable instruments law remain to be enacted, several of which are now in the midst of legislative debate. Both the public and the private sector need assistance to understand these laws. The widespread energy and enthusiasm of the Estonian peoples to rejoin the West will assist in maintaining the process of transformation. Foreign ventures have been slow to invest in Estonia because the local market is small; substantial investment will be required to penetrate regional markets, and regional political risks remain high.

There has been significant progress in the area of privatization. Approximately 60% of small-medium sized enterprises have now been privatized. An Estonian privatization agency, modeled after the German Treuhandanstalt was created in November 1992 and has begun the second of three privatization tranches of large and small enterprises. Return of land and other real property to previous owners as well as privatization of state-owned housing have been hampered by political debate and lack of adequate administrative resources, however.

Major restructuring of trade patterns has accompanied currency reform, with the leadership of the Estonian center-right government strongly committed to expanding trade with the West. Trade with the former Soviet Republics has declined from about 90% to 30%, partly due to payments difficulties accompanying the introduction of the kroon. Significant economic downsizing has occurred in the process. It is estimated that the economy contracted approximately 30% in 1992. Much of Estonia's heavy industry which served the Soviet military complex has virtually stopped production. Loss of these markets has contributed to economic dislocations. Bureau of Statistics figures for May 1993 revealed that the production of paper decreased 86%, equipment 73%, metals 71%,

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flour and cereal 69%, cement 65%, leather and shoes 57%, chemicals 55% and peat 54%. These represent information only from state firms. In the first quarter, GNP declined 12% and inflation was 9%. But taken together with estimates of private production, the Bureau estimates that GDP actually increased 3% in the first quarter. Estonia has experienced a sharp increase in both imports and exports with industrialized countries, with Finland replacing Russia as Estonia's largest trading partner. Inflation has also steadily declined since the kroon's introduction from over 17.6% in August 1992 to 3.6% in March 1993, and 1.3% in June 1993.

In contrast to the Winter of 1991-92, food is in abundant supply and market forces are governing most prices and the availability of products. There has been a surge in the importation of food products and there is now growing anxiety over the ability of the domestic agricultural sector's ability to compete. Some consideration has been given to introducing selective tariffs and anti-dumping legislation to protect the agricultural sector, but no firm decisions have been made.

While the country has been relatively successful in creating new business start-ups, stimulating the growth of the private sector will require manpower and entrepreneurial training and an infusion of foreign investment capital. Small scale foreign investment has grown significantly, but larger investment projects have been minimal due to the relatively small size of the local market, the lack of mortgage and land ownership laws, and the political risks associated with Russian troop presence. Unemployment remained relatively steady at about 2-5% in 1992, with most unemployment being registered at 9-11% in the Northeast region.

Further economic progress is also being hampered by the lack of confidence in the banking system. Estonia recently weathered a banking crisis, when three of the largest banks in Estonia were placed under moratorium. The Estonian central bank has imposed stiffer regulatory controls in an effort to reform the sector, but bank supervision is still inadequate by Western standards. Currently, there is a major credit crunch in the country which is hampering the start-up of new businesses and the expansion of existing firms. Of the 48 commercial banks operating at the time the new currency was introduced in June 1992, less than twenty are expected to receive new bank licenses since most will not meet the minimum US \$1.2 million capital deposit requirement. While most Estonian banks are relatively liquid, lending is very conservative due to relatively high risk factors, orientation of banks toward currency and commodity trading, and the absence of legislation providing for mortgages and collateral.

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Estonia has few natural resources to produce goods for the international market - timber, oil-shale to generate electricity and produce chemicals, fish, and agricultural produce, all of which are in surplus in the Western marketplace. Raw materials for technical and finished goods come almost entirely from foreign sources. Consequently, Estonia continues to retain strong dependencies on Russia for raw materials and markets. The deteriorating economic situation in Russia has affected both countries trade patterns.

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